

BUYER BEWARE – THIRD-PARTY VALUATION REPORTS ARE NOT CREATED EQUALLY

CRAIG TER BOSS OF EISNERAMPER LLP EXAMINES THE PROS AND CONS OF THE TYPES OF REPORTS OFFERED BY THIRD-PARTY VALUATION FIRMS



Craig Ter Boss,

CFA, EisnerAmper LLP, is a director in EisnerAmper's Corporate Finance Group with more than 16 years' experience specialising in valuation services for alternative asset managers including private equity, venture capital, and hedge funds.

Since the financial crises of 2008, the regulatory environment and the need to comply with global accounting standards have created a demand by investors for a robust and transparent valuation process by investment advisors. In response to this demand, investment advisors, who are ultimately responsible for the valuation of their illiquid assets, have often utilised third-party valuation firms in an effort to mitigate valuation risk and facilitate a more efficient audit process. However, the services provided by the third-party valuation firms, and ultimately the deliverable product, are not created equally and the reliance on these reports by investors, regulators and auditors varies greatly.

Third-party valuation firms offer a variety of services and reports in connection with valuing illiquid assets. However, the approaches employed and the reports delivered by these firms vary significantly and typically fall into four categories: negative assurance, positive assurance, a full valuation report and a limited scope report. The following discussion will highlight the positive and negative attributes of each type of report:

NEGATIVE ASSURANCE

In a typical negative assurance engagement, the valuation firm does not perform its own valuation but reviews the investment advisor's valuation to determine if the methodology/methodologies and calculations undertaken appear unreasonable. This type of report costs less in comparison with the other reports. The use of the negative assurance report has diminished greatly due to the lack of acceptance by audit firms, regulators and investors as it is not an independent valuation.

POSITIVE ASSURANCE

Upon the growing lack of acceptance of the negative assurance reports, the language of those reports was altered in order to strengthen their basis of valuation and calculations. In a typical positive assurance engagement, the valuation firm still does not perform its own valuation but reviews the investment advisor's valuation and relies on data provided by the investment advisor to determine that the methodology/methodologies, assumptions and calculations undertaken appear reasonable. As this opinion is not an independent valuation either, the use of the posi-

tive assurance report has diminished in recent years due to heightened scrutiny by auditors, regulators and investors.

FULL VALUATION REPORT

In connection with the preparation of a typical full valuation report, the valuation firm performs its own valuation by selecting the methodology/methodologies, the appropriate valuation assumptions based on direct discussions with investee company management, and other procedures that they deem appropriate. The concluded value may be a point estimate or a range of values. This opinion is typically considered an independent valuation. The popularity of these reports is hampered by the cost and time-to-complete associated with them. These reports have a higher rate of acceptance by audit firms; however, if the range of values is too large, acceptance may be lessened.

LIMITED VALUATION REPORT

To decrease the time to complete and the cost associated with the preparation of full valuation reports, the limited scope valuation has evolved into a popular alternative. In a typical limited scope valuation engagement, the valuation firm performs its own valuation by selecting the methodology/methodologies and the appropriate valuation assumptions based on direct discussions with the investment advisor but typically not the investee company management. The concluded value may be a point estimate or a range of values. This opinion is typically considered an independent valuation but the reliance on an investment advisor's analysis without further verification may draw scrutiny from auditors, regulators and investors. The use of these reports has increased due to a higher rate of acceptance and lower cost. However, similar to the full valuation reports, acceptance may be hindered if the range of values is too large or if support for the underlying assumptions is limited.

The type of report provided by a valuation firm may not mitigate valuation risk if the firm is not independent nor improve the audit process if the firm only relies on information provided by the investment advisor. To ensure a robust and transparent valuation process, there should be a clear valuation policy that is appropriately implemented by the investment advisor, utilising appropriate valuation methodologies. Regardless of the type of report prepared by a valuation firm, the responsibility of the valuation of illiquid assets lies with the investment advisor. ■